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C O N F I D E N T I A L SECTION 01 OF 03 SEOUL 001727

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STATE FOR E, EEB, AND EAP/K, PASS TO FEDERAL RESERVE BANK
OF NEW YORK - CHOI & BOEGE,
TREASURY FOR OASIA/POGGI AND HAARSAAGER
NSC FOR TONG

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SUMMARY

¶1. (C) The Korean won hit a nine-year high versus the Japanese yen on June 1, prompting the Ministry of Commerce, Industry, and Energy publicly to ask the Ministry of Finance and Economy (MOFE) "to pursue currency stability and strengthen export supports." Earlier in May, the won's appreciation took center stage for the ROKG at its Trilateral Finance Ministerial with Japanese and Chinese counterparts in Kyoto. The won has climbed 18.5 percent against the yen over the past two years compared to an 8.3-percent appreciation relative to the dollar. Some MOFE officials attribute the won/yen trend partly to increased currency and interest rate speculation by foreign banks here and are concerned about a concomitant spike in short-term foreign exchange (FX) borrowing. As a result of these pressures, MOFE is likely to step up FX market monitoring but avoid imposing non-market controls. END SUMMARY.

Foreign Exchange Intervention

¶2. (SBU) Following several queries to banks about their FX acquisitions, MOFE intervened in the FX market on May 17. MOFE and the Bank of Korea (BoK) publicly announced their intention to halt the recent won appreciation and bought dollars and yen worth about USD 500 million. After the rapidly executed intervention, the won weakened by 4.10 won per dollar to 928.1 won from the previous day, while softening to 7.7 won per yen. This was MOFE's first intervention since December 6, 2006. Since May 17, the won-dollar and won-yen rates have hovered around 927 won and 7.7 won, respectively, not far from previous highs. Market analysts acknowledge the BoK's May 17th intervention seems to have helped curb further appreciation for now, keeping the won/yen in a tight range. However, they argue the won's strengthening trend could reassert itself since market participants appear to be discounting the possibility of

Japanese interest rate hikes.

Trilateral

¶3. (C) In discussions with us, Korean finance authorities maintain the won's recent gains against the yen are unjustifiable in terms of fundamental economic factors. They point to Korea's chronically large trade deficit with Japan as the main factor that flies in the face of the won's continued appreciation. Perhaps more importantly, the depreciating yen hurts Korean exports to Japan, while bolstering Korean dependence on Japanese machinery and part imports, up 10.8 percent in the first four months of 2007.

¶4. (C) Against this backdrop, the won's appreciation took center stage for the ROKG at its Trilateral Finance Ministerial with Japanese and Chinese counterparts on the fringe of the Kyoto Asian Development Bank meeting in early May. MOFE International Finance Bureau Director Kim Yoon-Kyung recently told us the ROKG is "extremely frustrated" by Japanese Finance Minister Omi's insistence that the Yen's value is market-determined and his refusal to "help untie the choking knot of the Japanese yen carry trade."

¶5. (U) Nonetheless, the May 4th Trilateral Ministerial did see the Chinese, Japanese, and Korean finance ministers agree to enhance cooperation in regional currency markets, and to promote a new Asian bond market initiative. The three ministers undertook to strengthen information exchanges on regional financial volatility. They also boosted their bilateral FX swap arrangements to USD 80 billion under the

Chiang Mai Initiative (CMI) system. (Note: The CMI is a regional accord to fend off currency crises, adopted during the ASEAN-plus-three meeting held in Chiang Mai, Thailand in
¶2000. It aims at lifting member nations out of financial crisis by establishing a network of currency swap contracts among member countries. End note.)

Foreign Banks

¶6. (SBU) Korea's complex FX situation has also put a glaring spotlight on the role of foreign banks here. On April 19, the BoK urged thirty-six foreign banks operating in Korea to reduce their FX borrowing, particularly in Japanese yen. The BoK noted short-term FX bank debt stood at a record USD 113.6 billion in late 2006, up 72 percent from 2005 and exceeding USD 100 billion for the first time. Short-term debt (maturing in one year or less) accounted for 43.1 percent of all FX borrowing, up from 34.7 percent in late
¶2005. This trend persists into 2007, as banks ramped up $12.7 billion in new loans in the first quarter of the year, including USD 11.3 billion assumed by foreign banks. Our MOFE contacts attribute the FX loan rise partly to the yen carry trade, i.e., borrowing yen, converting it into won, and parking it in interest-bearing securities to speculate on continued won appreciation.

¶7. (C) From a systemic perspective, finance authorities seem to be focusing on foreign bank branches in their investigation of short FX debt flows because:

--only about 28 percent can be explained in terms of hedging activity surrounding Korean ship-builder receipts. Korean shipbuilders are believed to hedge around 70-80 percent of their dollar exposure, amounting to about USD 40 billion in both 2006 and 2007.

--domestic commercial banks are subject to FX liquid asset ratios, which basically limit their net open positions in FX and ensure they do not assume excessive risk.

¶8. (C) However, foreign bank branches are not subject to the same regulations. Their capital is incorporated abroad

and their FX risks regulated by the country in which they are incorporated. Since foreign bank branches are mainly driving the increase in short-term debt, MOFE and the BoK are now more frequently requesting information from the branches on their FX positions. MOFE apparently believes foreign banks are borrowing FX at lower interest-rate costs and exploiting the spread on Korean treasuries. In addition, MOFE officials suspect some of the yen swapped into won may be channeled into on-lending to small- and medium-sized enterprises, thereby raising BoK concerns about excessive risk-taking in the market as a whole. The IMF's Article IV team is currently in Seoul investigating these and other issues till June 15.

COMMENT

¶9. (C) We believe MOFE's concern about the sharp increase in short-term FX borrowing by foreign banks does not portend any policy change. MOFE and BoK are unlikely to curtail FX borrowing directly because they are reluctant to go against their strong public commitments to the market mechanism. However, the BoK will probably continue to intervene indirectly in the FX market, as needed. Recent short-term FX borrowing is a natural reaction to global trends in the Yen carry trade coupled with rational expectations of the Korean economy backed by ample liquidity and strong exports. In light of the upcoming December 2007 Presidential election, the BoK can be expected to keep walking a fine line on its soft monetary policy, providing sufficient liquidity to stimulate the economy, while watching for any signs of overheating. END COMMENT.

STANTON